

109TH CONGRESS  
2D SESSION

# S. 3838

To amend the Internal Revenue Code of 1986 to provide for S corporation reform, and for other purposes.

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IN THE SENATE OF THE UNITED STATES

AUGUST 3, 2006

Mr. HATCH (for himself and Mrs. LINCOLN) introduced the following bill;  
which was read twice and referred to the Committee on Finance

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## A BILL

To amend the Internal Revenue Code of 1986 to provide  
for S corporation reform, and for other purposes.

1 *Be it enacted by the Senate and House of Representa-*  
2 *tives of the United States of America in Congress assembled,*

3 **SECTION 1. SHORT TITLE; REFERENCE; TABLE OF CON-**  
4 **TENTS.**

5 (a) SHORT TITLE.—This Act may be cited as the “S  
6 Corporation Reform Act of 2006”.

7 (b) AMENDMENT OF 1986 CODE.—Except as other-  
8 wise expressly provided, whenever in this Act an amend-  
9 ment or repeal is expressed in terms of an amendment  
10 to, or repeal of, a section or other provision, the reference

1 shall be considered to be made to a section or other provi-  
 2 sion of the Internal Revenue Code of 1986.

3 (c) TABLE OF CONTENTS.—The table of contents for  
 4 this Act is as follows:

Sec. 1. Short title; reference; table of contents.

#### TITLE I—ELIGIBLE SHAREHOLDERS OF AN S CORPORATION

Sec. 101. Nonresident aliens allowed to be shareholders.

Sec. 102. Expansion of S corporation eligible shareholders to include IRAS.

#### TITLE II—QUALIFICATION AND ELIGIBILITY REQUIREMENTS OF S CORPORATIONS

Sec. 201. Issuance of preferred stock permitted.

Sec. 202. Safe harbor expanded to include convertible debt.

Sec. 203. Repeal of excessive passive investment income as a termination event.

Sec. 204. Modifications to passive income rules.

Sec. 205. Adjustment to basis of s corporation stock for certain charitable con-  
 tributions.

#### TITLE III—TREATMENT OF S CORPORATION SHAREHOLDERS

Sec. 301. Treatment of losses to shareholders.

Sec. 302. Deductibility of interest expense incurred by an electing small busi-  
 ness trust to acquire S corporation stock.

Sec. 303. Back to back loans as indebtedness.

#### TITLE IV—EXPANSION OF S CORPORATION ELIGIBILITY FOR BANKS

Sec. 401. Treatment of qualifying director shares.

Sec. 402. Recapture of bad debt reserves.

#### TITLE V—QUALIFIED SUBCHAPTER S SUBSIDIARIES

Sec. 501. Treatment of the sale of interest in a qualified subchapter S sub-  
 sidiary.

#### TITLE VI—ADDITIONAL PROVISIONS

Sec. 601. Elimination of all earnings and profits attributable to pre-1983 years.

Sec. 602. Repeal of LIFO recapture tax.

Sec. 603. Expansion of post-termination transition period.

Sec. 604. Reduction in tax rate on excess net passive income.

Sec. 605. Increase in cap on qualified small issue bonds.

Sec. 606. Special rules of application.

1 **TITLE I—ELIGIBLE SHARE-**  
 2 **HOLDERS OF AN S CORPORA-**  
 3 **TION**

4 **SEC. 101. NONRESIDENT ALIENS ALLOWED TO BE SHARE-**  
 5 **HOLDERS.**

6 (a) NONRESIDENT ALIENS ALLOWED TO BE SHARE-  
 7 HOLDERS.—

8 (1) IN GENERAL.—Paragraph (1) of section  
 9 1361(b) (defining small business corporation) is  
 10 amended—

11 (A) by adding “and” at the end of sub-  
 12 paragraph (B),

13 (B) by striking subparagraph (C), and

14 (C) by redesignating subparagraph (D) as  
 15 subparagraph (C).

16 (2) CONFORMING AMENDMENTS.—

17 (A) Paragraph (4) and (5)(A) of section  
 18 1361(c) (relating to special rules for applying  
 19 subsection (b)) are each amended by striking  
 20 “subsection (b)(1)(D)” and inserting “sub-  
 21 section (b)(1)(C)”.

22 (B) Clause (i) of section 280G(b)(5)(A)  
 23 (relating to general rule for exemption for small  
 24 business corporations, etc.) is amended by strik-

1           ing “but without regard to paragraph (1)(C)  
2           thereof”.

3           (b) NONRESIDENT ALIEN SHAREHOLDER TREATED  
4 AS ENGAGED IN TRADE OR BUSINESS WITHIN UNITED  
5 STATES.—

6           (1) IN GENERAL.—Section 875 is amended—

7                   (A) by striking “and” at the end of para-  
8           graph (1),

9                   (B) by striking the period at the end of  
10          paragraph (2) and inserting “, and”, and

11                  (C) by adding at the end the following new  
12          paragraph:

13                “(3) a nonresident alien individual shall be con-  
14          sidered as being engaged in a trade or business  
15          within the United States if the S corporation of  
16          which such individual is a shareholder is so en-  
17          gaged.”.

18           (2) PRO RATA SHARE OF S CORPORATION IN-  
19          COME.—The last sentence of section 1441(b) (relat-  
20          ing to income items) is amended to read as follows:  
21          “In the case of a nonresident alien individual who is  
22          a member of a domestic partnership or a share-  
23          holder of an S corporation, the items of income re-  
24          ferred to in subsection (a) shall be treated as refer-  
25          ring to items specified in this subsection included in

1 his distributive share of the income of such partner-  
 2 ship or in his pro rata share of the income of such  
 3 S corporation.”.

4 (3) APPLICATION OF WITHHOLDING TAX ON  
 5 NONRESIDENT ALIEN SHAREHOLDERS.—Section  
 6 1446 (relating to withholding tax on foreign part-  
 7 ners’ share of effectively connected income) is  
 8 amended by redesignating subsection (f) as sub-  
 9 section (g) and by inserting after subsection (e) the  
 10 following new subsection:

11 “(f) S CORPORATION TREATED AS PARTNERSHIP,  
 12 ETC.—For purposes of this section—

13 “(1) an S corporation shall be treated as a  
 14 partnership,

15 “(2) the shareholders of such corporation shall  
 16 be treated as partners of such partnership,

17 “(3) any reference to section 704 shall be treat-  
 18 ed as a reference to section 1366, and

19 “(4) no withholding tax under subsection (a)  
 20 shall be required in the case of any income realized  
 21 by such corporation and allocable to a shareholder  
 22 which is an electing small business trust (as defined  
 23 in section 1361(e)).”.

24 (4) CONFORMING AMENDMENTS.—

1 (A) The heading of section 875 is amended  
2 to read as follows:

3 **“SEC. 875. PARTNERSHIPS; BENEFICIARIES OF ESTATES**  
4 **AND TRUSTS; S CORPORATIONS.”.**

5 (B) The heading of section 1446 is amend-  
6 ed to read as follows:

7 **“SEC. 1446. WITHHOLDING TAX ON FOREIGN PARTNERS’**  
8 **AND S CORPORATION SHAREHOLDERS’**  
9 **SHARE OF EFFECTIVELY CONNECTED IN-**  
10 **COME.”.**

11 (5) CLERICAL AMENDMENTS.—

12 (A) The item relating to section 875 in the  
13 table of sections for subpart A of part II of  
14 subchapter N of chapter 1 is amended to read  
15 as follows:

“Sec. 875. Partnerships; beneficiaries of estates and trusts; S corporations.”.

16 (B) The item relating to section 1446 in  
17 the table of sections for subchapter A of chap-  
18 ter 3 is amended to read as follows:

“Sec. 1446 Withholding tax on foreign partners’ and S corporation share-  
holders’ share of effectively connected income.”.

19 (C) PERMANENT ESTABLISHMENT OF  
20 PARTNERS AND S CORPORATION SHARE-  
21 HOLDERS.—Section 894 (relating to income af-  
22 fected by treaty) is amended by redesignating  
23 subsection (c) as subsection (d) and by insert-

1           ing after subsection (b) the following new sub-  
2           section:

3           “(c) PERMANENT ESTABLISHMENT OF PARTNERS  
4 AND S CORPORATION SHAREHOLDERS.—If a partnership  
5 or S corporation has a permanent establishment in the  
6 United States (within the meaning of a treaty to which  
7 the United States is a party) at any time during a taxable  
8 year of such entity, a nonresident alien individual or for-  
9 eign corporation which is a partner in such partnership,  
10 or a nonresident alien individual who is a shareholder in  
11 such S corporation, shall be treated as having a permanent  
12 establishment in the United States for purposes of such  
13 treaty.”.

14           (c) APPLICATION OF OTHER WITHHOLDING TAX  
15 RULES ON NONRESIDENT ALIEN SHAREHOLDERS.—

16           (1) SECTION 1441.—Section 1441 (relating to  
17 withholding of tax on nonresident aliens) is amended  
18 by redesignating subsection (g) as subsection (h)  
19 and by inserting after subsection (f) the following  
20 new subsection:

21           “(g) S CORPORATION TREATED AS PARTNERSHIP,  
22 ETC.—For purposes of this section—

23           “(1) an S corporation shall be treated as a  
24 partnership,

1           “(2) the shareholders of such corporation shall  
2       be treated as partners of such partnership, and

3           “(3) no deduction or withholding under sub-  
4       section (a) shall be required in the case of any item  
5       of income realized by such corporation and allocable  
6       to a shareholder which is an electing small business  
7       trust (as defined in section 1361(e)).”.

8           (2) SECTION 1445.—Section 1445(e) (relating  
9       to special rules relating to distributions, etc., by cor-  
10      porations, partnerships, trusts, or estates) is amend-  
11      ed by redesignating paragraph (6) as paragraph (7)  
12      and by inserting after paragraph (5) the following  
13      new paragraph:

14           “(6) S CORPORATION TREATED AS PARTNER-  
15      SHIP, ETC.—For purposes of this section—

16           “(A) an S corporation shall be treated as  
17      a partnership, and

18           “(B) the shareholders of such corporation  
19      shall be treated as partners of such partnership,  
20      and

21           “(C) no deduction or withholding under  
22      subsection (a) shall be required in the case of  
23      any gain realized by such corporation and allo-  
24      cable to a shareholder which is an electing small  
25      business trust (as defined in section 1361(e)).”.

1 (d) ADDITIONAL CONFORMING AMENDMENTS.—

2 (1) Section 1361(c)(2)(A)(i) is amended by  
3 striking “who is a citizen or resident of the United  
4 States”.

5 (2) Section 1361(d)(3)(B) is amended by strik-  
6 ing “who is a citizen or resident of the United  
7 States”.

8 (3) Section 1361(e)(2) is amended by inserting  
9 “(including a nonresident alien)” after “person” the  
10 first place it appears.

11 (e) EFFECTIVE DATE.—The amendments made by  
12 this section shall apply to taxable years beginning after  
13 December 31, 2006.

14 **SEC. 102. EXPANSION OF S CORPORATION ELIGIBLE**  
15 **SHAREHOLDERS TO INCLUDE IRAS.**

16 (a) IN GENERAL.—Clause (vi) of section  
17 1361(c)(2)(A) (relating to certain trusts permitted as  
18 shareholders) is amended to read as follows:

19 “(vi) A trust which constitutes an in-  
20 dividual retirement account under section  
21 408(a), including one designated as a Roth  
22 IRA under section 408A.”.

23 (b) SALE OF STOCK IN IRA RELATING TO S COR-  
24 PORATION ELECTION EXEMPT FROM PROHIBITED  
25 TRANSACTION RULES.—Paragraph (16) of section

1 4975(d) (relating to exemptions) is amended to read as  
2 follows:

3 “(16) a sale of stock held by a trust which con-  
4 stitutes an individual retirement account under sec-  
5 tion 408(a) to the individual for whose benefit such  
6 account is established if

7 “(A) such sale is pursuant to an election  
8 under section 1362(a) by the issuer of such  
9 stock,

10 “(B) such sale is for fair market value at  
11 the time of sale (as established by an inde-  
12 pendent appraiser) and the terms of the sale  
13 are otherwise at least as favorable to such trust  
14 as the terms that would apply on a sale to an  
15 unrelated party,

16 “(C) such trust does not pay any commis-  
17 sions, costs, or other expenses in connection  
18 with the sale, and

19 “(D) the stock is sold in a single trans-  
20 action for cash not later than 120 days after  
21 the S corporation election is made.”.

22 (c) EFFECTIVE DATE.—The amendments made by  
23 this section shall take effect on the date of the enactment  
24 of this Act.

1 **TITLE II—QUALIFICATION AND**  
 2 **ELIGIBILITY REQUIREMENTS**  
 3 **OF S CORPORATIONS**

4 **SEC. 201. ISSUANCE OF PREFERRED STOCK PERMITTED.**

5 (a) IN GENERAL.—Section 1361 (defining S corpora-  
 6 tion) is amended by adding at the end the following new  
 7 subsection:

8 “(f) TREATMENT OF QUALIFIED PREFERRED  
 9 STOCK.—

10 “(1) IN GENERAL.—For purposes of this sub-  
 11 chapter—

12 “(A) qualified preferred stock shall not be  
 13 treated as a second class of stock, and

14 “(B) no person shall be treated as a share-  
 15 holder of the corporation by reason of holding  
 16 qualified preferred stock.

17 “(2) QUALIFIED PREFERRED STOCK DE-  
 18 FINED.—For purposes of this subsection, the term  
 19 ‘qualified preferred stock’ means stock which meets  
 20 the requirements of subparagraphs (A), (B), and (C)  
 21 of section 1504(a)(4). Stock shall not fail to be  
 22 treated as qualified preferred stock merely because  
 23 it is convertible into other stock.

24 “(3) DISTRIBUTIONS.—A distribution (not in  
 25 part or full payment in exchange for stock) made by

1 the corporation with respect to qualified preferred  
 2 stock shall be includible as ordinary income of the  
 3 holder and deductible to the corporation as an ex-  
 4 pense in computing taxable income under section  
 5 1363(b) in the year such distribution is received.”.

6 (b) CONFORMING AMENDMENTS.—

7 (1) Paragraph (1) of section 1361(b) is amend-  
 8 ed by inserting “, except as provided in subsection  
 9 (f),” before “which does not”.

10 (2) Subsection (a) of section 1366 is amended  
 11 by adding at the end the following new paragraph:

12 “(3) ALLOCATION WITH RESPECT TO QUALI-  
 13 FIED PREFERRED STOCK.—The holders of qualified  
 14 preferred stock (as defined in section 1361(f)) shall  
 15 not, with respect to such stock, be allocated any of  
 16 the items described in paragraph (1).”.

17 (3) So much of clause (ii) of section  
 18 354(a)(2)(C) as precedes subclause (II) is amended  
 19 to read as follows:

20 “(ii) RECAPITALIZATION OF FAMILY-  
 21 OWNED CORPORATIONS AND S CORPORA-  
 22 TIONS.—

23 “(I) IN GENERAL.—Clause (i)  
 24 shall not apply in the case of a recap-  
 25 italization under section 368(a)(I)(E)

1 of a family-owned corporation or S  
2 corporation.”.

3 (4) Subsection (a) of section 1373 is amended  
4 by striking “and” at the end of paragraph (1), by  
5 striking the period at the end of paragraph (2) and  
6 inserting “, and”, and by adding at the end the fol-  
7 lowing new paragraph:

8 “(3) no amount of an expense deductible under  
9 this subchapter by reason of section 1361(f)(3) shall  
10 be apportioned or allocated to such income.”.

11 (c) EFFECTIVE DATE.—The amendments made by  
12 this section shall apply to taxable years beginning after  
13 December 31, 2006.

14 **SEC. 202. SAFE HARBOR EXPANDED TO INCLUDE CONVERT-**  
15 **IBLE DEBT.**

16 (a) IN GENERAL.—Subparagraph (B) of section  
17 1361(c)(5) (defining straight debt) is amended by striking  
18 clauses (ii) and (iii) and inserting the following new  
19 clauses:

20 “(ii) in any case in which the terms of  
21 such promise include a provision under  
22 which the obligation to pay may be con-  
23 verted (directly or indirectly) into stock of  
24 the corporation, such terms, taken as a  
25 whole, are substantially the same as the

1 terms which could have been obtained on  
 2 the effective date of the promise from a  
 3 person which is not a related person (with-  
 4 in the meaning of section 465(b)(3)(C)) to  
 5 the S corporation or its shareholders, and

6 “(iii) the creditor is—

7 “(I) an individual,

8 “(II) an estate,

9 “(III) a trust described in para-  
 10 graph (2),

11 “(IV) an exempt organization de-  
 12 scribed in paragraph (6), or

13 “(V) a person which is actively  
 14 and regularly engaged in the business  
 15 of lending money.”.

16 (b) EFFECTIVE DATE.—The amendment made by  
 17 this section shall apply to taxable years beginning after  
 18 December 31, 2006.

19 **SEC. 203. REPEAL OF EXCESSIVE PASSIVE INVESTMENT IN-**  
 20 **COME AS A TERMINATION EVENT.**

21 (a) IN GENERAL.—Section 1362(d) (relating to ter-  
 22 mination) is amended by striking paragraph (3).

23 (b) CONFORMING AMENDMENTS.—

24 (1) Section 1362(f)(1) is amended by striking  
 25 “or (3)”.

1           (2) Clause (i) of section 1042(c)(4)(A) is  
 2           amended by striking “section 1362(d)(3)(C)” and  
 3           inserting “section 1375(b)(3)”.

4           (c) EFFECTIVE DATE.—The amendments made by  
 5 this section shall apply to taxable years beginning after  
 6 December 31, 2006.

7 **SEC. 204. MODIFICATIONS TO PASSIVE INCOME RULES.**

8           (a) INCREASED LIMIT.—

9           (1) IN GENERAL.—Subsection (a)(2) of section  
 10 1375 (relating to tax imposed when passive invest-  
 11 ment income of corporation having accumulated  
 12 earnings and profits exceeds 25 percent of gross re-  
 13 ceipts) is amended by striking “25 percent” and in-  
 14 serting “60 percent”.

15           (2) CONFORMING AMENDMENTS.—

16           (A) Subparagraph (J) of section 26(b)(2)  
 17 is amended by striking “25 percent” and insert-  
 18 ing “60 percent”.

19           (B) Clause (i) of section 1375(b)(1)(A) is  
 20 amended by striking “25 percent” and inserting  
 21 “60 percent”.

22           (C) The heading for section 1375 is  
 23 amended by striking “**25 PERCENT**” and in-  
 24 serting “**60 PERCENT**”.

1 (D) The table of sections for part III of  
 2 subchapter S of chapter 1 is amended by strik-  
 3 ing “25 percent” in the item relating to section  
 4 1375 and inserting “60 percent”.

5 (b) REPEAL OF PASSIVE INCOME CAPITAL GAIN  
 6 CATEGORY.—

7 (1) IN GENERAL.—Subsection (b) of section  
 8 1375 (relating to tax imposed when passive invest-  
 9 ment income of corporation having accumulated  
 10 earnings and profits exceeds 60 percent of gross re-  
 11 cepts), as amended by subsection (a), is amended by  
 12 striking paragraphs (3) and (4) and inserting the  
 13 following new paragraph:

14 “(3) PASSIVE INVESTMENT INCOME DE-  
 15 FINED.—

16 “(A) IN GENERAL.—Except as otherwise  
 17 provided in this paragraph, the term ‘passive  
 18 investment income’ means gross receipts de-  
 19 rived from royalties, rents, dividends, interest,  
 20 and annuities.

21 “(B) EXCEPTION FOR INTEREST ON  
 22 NOTES FROM SALES OF INVENTORY.—The term  
 23 ‘passive investment income’ shall not include in-  
 24 terest on any obligation acquired in the ordi-  
 25 nary course of the corporation’s trade or busi-

1           ness from its sale of property described in sec-  
2           tion 1221(a)(1).

3           “(C) TREATMENT OF CERTAIN LENDING  
4           OR FINANCE COMPANIES.—If the S corporation  
5           meets the requirements of section 542(c)(6) for  
6           the taxable year, the term ‘passive investment  
7           income’ shall not include gross receipts for the  
8           taxable year which are derived directly from the  
9           active and regular conduct of a lending or fi-  
10          nance business (as defined in section  
11          542(d)(1)).

12          “(D) TREATMENT OF CERTAIN DIVI-  
13          DENDS.—If an S corporation holds stock in a  
14          C corporation meeting the requirements of sec-  
15          tion 1504(a)(2), the term ‘passive investment  
16          income’ shall not include dividends from such C  
17          corporation to the extent such dividends are at-  
18          tributable to the earnings and profits of such C  
19          corporation derived from the active conduct of  
20          a trade or business.

21          “(E) COORDINATION WITH SECTION  
22          1374.—The amount of passive investment in-  
23          come shall be determined by not taking into ac-  
24          count any recognized built-in gain or loss of the  
25          S corporation for any taxable year in the rec-

1           ognition period. Terms used in the preceding  
 2           sentence shall have the same respective mean-  
 3           ing as when used in section 1374.”.

4           (2) CONFORMING AMENDMENTS.—Section  
 5           1375(d) is amended by striking “subchapter C” both  
 6           places it appears and inserting “accumulated”.

7           (c) EFFECTIVE DATE.—The amendments made by  
 8           this section shall apply to taxable years beginning after  
 9           December 31, 2006.

10 **SEC. 205. ADJUSTMENT TO BASIS OF S CORPORATION**  
 11 **STOCK FOR CERTAIN CHARITABLE CON-**  
 12 **TRIBUTIONS.**

13           (a) IN GENERAL.—Paragraph (1) of section 1367(a)  
 14           (relating to adjustments to basis of stock of shareholders,  
 15           etc.) is amended by striking “and” at the end of subpara-  
 16           graph (B), by striking the period at the end of subpara-  
 17           graph (C) and inserting “, and”, and by adding at the  
 18           end the following new subparagraph:

19                       “(D) the excess of the amount of the  
 20           shareholder’s proportionate share of any chari-  
 21           table contribution made by the S corporation  
 22           over the shareholder’s proportionate share of  
 23           the adjusted basis of the property contrib-  
 24           uted.”.

1 (b) EFFECTIVE DATE.—The amendments made by  
 2 this section shall apply to taxable years beginning after  
 3 December 31, 2006.

## 4 **TITLE III—TREATMENT OF S** 5 **CORPORATION SHAREHOLDERS**

### 6 **SEC. 301. TREATMENT OF LOSSES TO SHAREHOLDERS.**

7 (a) LIQUIDATIONS.—Section 331 (relating to gain or  
 8 loss to shareholders in corporate liquidations) is amended  
 9 by redesignating subsection (c) as subsection (d) and by  
 10 inserting after subsection (b) the following new subsection:

11 “(c) LOSS ON LIQUIDATIONS OF S CORPORATION.—

12 “(1) IN GENERAL.—The portion of any net loss  
 13 recognized by a shareholder of an S corporation (as  
 14 defined in section 1361(a)(1))—

15 “(A) on amounts received by such share-  
 16 holder in a distribution in complete liquidation  
 17 of such S corporation, or

18 “(B) on an installment obligation received  
 19 by such shareholder with respect to a sale or  
 20 exchange by the corporation during the 12-  
 21 month period beginning on the date a plan of  
 22 complete liquidation is adopted if the liquida-  
 23 tion is completed during such 12-month period,  
 24 which does not exceed the ordinary income  
 25 basis of stock of such S corporation in the

1 hands of such shareholder shall not be treated  
 2 as a loss from the sale or exchange of a capital  
 3 asset but shall be treated as an ordinary loss.

4 “(2) ORDINARY INCOME BASIS.—For purposes  
 5 of this subsection, the ordinary income basis of stock  
 6 of an S corporation in the hands of a shareholder of  
 7 such S corporation shall be an amount equal to the  
 8 portion of such shareholder’s basis in such stock  
 9 which is equal to the aggregate increases in such  
 10 basis under section 1367(a)(1) resulting from such  
 11 shareholder’s pro rata share of ordinary income of  
 12 such S corporation attributable to the complete liq-  
 13 uidation.”.

14 (b) SUSPENDED PASSIVE ACTIVITY LOSSES.—Para-  
 15 graph (3) of section 1371(b) is amended to read as fol-  
 16 lows:

17 “(3) TREATMENT OF S YEAR AS ELAPSED  
 18 YEAR; PASSIVE LOSSES.—Nothing in paragraphs (1)  
 19 and (2) shall prevent treating a taxable year for  
 20 which a corporation is an S corporation as a taxable  
 21 year for purposes of determining the number of tax-  
 22 able years to which an item may be carried back or  
 23 carried forward nor prevent the allowance of a pas-  
 24 sive activity loss deduction to the extent provided by  
 25 section 469(g).”.

1 (c) EFFECTIVE DATE.—The amendments made by  
 2 this section shall apply to taxable years beginning after  
 3 December 31, 2006.

4 **SEC. 302. DEDUCTIBILITY OF INTEREST EXPENSE IN-**  
 5 **CURRED BY AN ELECTING SMALL BUSINESS**  
 6 **TRUST TO ACQUIRE S CORPORATION STOCK.**

7 (a) IN GENERAL.—Subparagraph (C) of section  
 8 641(c)(2) (relating to modifications) is amended by insert-  
 9 ing after clause (iii) the following new clause:

10 “(iv) Any interest expense incurred to  
 11 acquire stock in an S corporation.”.

12 (b) EFFECTIVE DATE.—The amendment made by  
 13 this section shall apply to taxable years beginning after  
 14 December 31, 2006.

15 **SEC. 303. BACK TO BACK LOANS AS INDEBTEDNESS.**

16 (a) IN GENERAL.—Section 1366(d) (relating to spe-  
 17 cial rules for losses and deductions) is amended by adding  
 18 at the end the following new paragraph:

19 “(4) LOANS INCLUDED IN INDEBTEDNESS OF  
 20 AN S CORPORATION.—For purposes of subsection  
 21 (d), the indebtedness of an S corporation to the  
 22 shareholder shall include any loans made or acquired  
 23 (by purchase, gift, or distribution from another per-  
 24 son) by a shareholder to the S corporation, regard-  
 25 less of whether the funds loaned by the shareholder

1 to the S corporation were obtained by the share-  
 2 holder by means of a recourse loan from another  
 3 person (whether related or unrelated to the share-  
 4 holder).”.

5 (b) EFFECTIVE DATE.—The amendment made by  
 6 this section shall apply to taxable years beginning after  
 7 December 31, 2006.

## 8 **TITLE IV—EXPANSION OF S COR-** 9 **PORATION ELIGIBILITY FOR** 10 **BANKS**

### 11 **SEC. 401. TREATMENT OF QUALIFYING DIRECTOR SHARES.**

12 (a) IN GENERAL.—Section 1361 (defining S corpora-  
 13 tion), as amended by section 201(a), is amended by adding  
 14 at the end the following new subsection:

15 “(g) TREATMENT OF QUALIFYING DIRECTOR  
 16 SHARES.—

17 “(1) IN GENERAL.—For purposes of this sub-  
 18 chapter—

19 “(A) qualifying director shares shall not be  
 20 treated as a second class of stock, and

21 “(B) no person shall be treated as a share-  
 22 holder of the corporation by reason of holding  
 23 qualifying director shares.

24 “(2) QUALIFYING DIRECTOR SHARES DE-  
 25 FINED.—For purposes of this subsection, the term

1       ‘qualifying director shares’ means any shares of  
 2       stock in a bank (as defined in section 581) or in a  
 3       bank holding company registered as such with the  
 4       Federal Reserve System—

5               “(A) which are held by an individual solely  
 6               by reason of status as a director of such bank  
 7               or company or its controlled subsidiary; and

8               “(B) which are subject to an agreement  
 9               pursuant to which the holder is required to dis-  
 10              pose of the shares of stock upon termination of  
 11              the holder’s status as a director at the same  
 12              price as the individual acquired such shares of  
 13              stock.

14             “(3) DISTRIBUTIONS.—A distribution (not in  
 15             part or full payment in exchange for stock) made by  
 16             the corporation with respect to qualifying director  
 17             shares shall be includible as ordinary income of the  
 18             holder and deductible to the corporation as an ex-  
 19             pense in computing taxable income under section  
 20             1363(b) in the year such distribution is received.”.

21             (b) CONFORMING AMENDMENTS.—

22               (1) Section 1361(b)(1), as amended by section  
 23               201(b), is amended by striking “subsection (f)” and  
 24               inserting “subsections (f) and (g)”.

1           (2) Section 1366(a), as amended by section  
 2           201(b), is amended by adding at the end the fol-  
 3           lowing new paragraph:

4           “(4) ALLOCATION WITH RESPECT TO QUALI-  
 5           FYING DIRECTOR SHARES.—The holders of quali-  
 6           fying director shares (as defined in section 1361(g))  
 7           shall not, with respect to such shares of stock, be al-  
 8           located any of the items described in paragraph  
 9           (1).”.

10          (3) Section 1373(a), as amended by section  
 11          201(b), is amended by striking “and” at the end of  
 12          paragraph (2), by striking the period at the end of  
 13          paragraph (3) and inserting “, and”, and adding at  
 14          the end the following new paragraph:

15          “(4) no amount of an expense deductible under  
 16          this subchapter by reason of section 1361(g)(3) shall  
 17          be apportioned or allocated to such income.”.

18          (c) EFFECTIVE DATE.—The amendments made by  
 19          this section shall apply to taxable years beginning after  
 20          December 31, 1996.

21       **SEC. 402. RECAPTURE OF BAD DEBT RESERVES.**

22          Notwithstanding section 481 of the Internal Revenue  
 23          Code of 1986, with respect to any S corporation election  
 24          made by any bank in taxable years beginning after Decem-  
 25          ber 31, 1996, such bank may recognize built-in gains from

1 changing its accounting method for recognizing bad debts  
 2 from the reserve method under section 585 or 593 of such  
 3 Code to the charge-off method under section 166 of such  
 4 Code either in the taxable year ending with or beginning  
 5 with such an election.

## 6 **TITLE V—QUALIFIED**

### 7 **SUBCHAPTER S SUBSIDIARIES**

#### 8 **SEC. 501. TREATMENT OF THE SALE OF INTEREST IN A**

#### 9 **QUALIFIED SUBCHAPTER S SUBSIDIARY.**

10 (a) IN GENERAL.—Section 1361(b)(3) (relating to  
 11 treatment of certain wholly owned subsidiaries) is amend-  
 12 ed by adding at the end the following new subparagraph:

13 “(F) SPECIAL RULE ON TERMINATION.—

14 The tax treatment of the disposition of the  
 15 stock of the qualified subchapter S subsidiary  
 16 shall be determined as if such disposition  
 17 were—

18 “(i) a sale of the undivided interest in  
 19 the subsidiary’s assets based on the per-  
 20 centage of the stock transferred, and

21 “(ii) followed by a deemed contribu-  
 22 tion by the S corporation and the trans-  
 23 feree in a section 351 transaction.”.

1 (b) EFFECTIVE DATE.—The amendment made by  
 2 this section shall apply to taxable years beginning after  
 3 December 31, 1996.

4 **TITLE VI—ADDITIONAL**  
 5 **PROVISIONS**

6 **SEC. 601. ELIMINATION OF ALL EARNINGS AND PROFITS**  
 7 **ATTRIBUTABLE TO PRE-1983 YEARS.**

8 (a) IN GENERAL.—Subsection (a) of section 1311 of  
 9 the Small Business Job Protection Act of 1996 is amend-  
 10 ed to read as follows:

11 “(a) IN GENERAL.—If a corporation was an electing  
 12 small business corporation under subchapter S of chapter  
 13 1 of the Internal Revenue Code of 1986 for any taxable  
 14 year beginning before January 1, 1983, the amount of  
 15 such corporation’s accumulated earnings and profits (as  
 16 of the beginning of any taxable year beginning after De-  
 17 cember 31, 1982) shall be reduced by an amount equal  
 18 to the portion (if any) of such accumulated earnings and  
 19 profits which were accumulated in any taxable year begin-  
 20 ning before January 1, 1983, for which such corporation  
 21 was an electing small business corporation under such  
 22 subchapter S.”.

23 (b) EFFECTIVE DATE.—The amendment made by  
 24 this section shall apply to taxable years beginning after  
 25 December 31, 1996.

1 **SEC. 602. REPEAL OF LIFO RECAPTURE TAX.**

2 (a) IN GENERAL.—Section 1363 (relating to effect  
3 on election on corporations) is amended by striking sub-  
4 section (d).

5 (b) EFFECTIVE DATE.—The amendment made by  
6 this section shall apply to elections made after the date  
7 of the enactment of this Act.

8 **SEC. 603. EXPANSION OF POST-TERMINATION TRANSITION**  
9 **PERIOD.**

10 (a) IN GENERAL.—Clause (ii) of section  
11 1377(b)(1)(A) (defining post-termination transition pe-  
12 riod) is amended to read as follows:

13 “(ii) the date on which any refund or  
14 credit of any overpayment of tax with re-  
15 spect to the return for such last year as an  
16 S corporation is prevented by the operation  
17 of any law or rule of law (including res ju-  
18 dicata),”.

19 (b) EFFECTIVE DATE.—The amendment made by  
20 this section shall apply to periods beginning after the date  
21 of the enactment of this Act.

22 **SEC. 604. REDUCTION IN TAX RATE ON EXCESS NET PAS-**  
23 **SIVE INCOME.**

24 (a) IN GENERAL.—Section 1375(a) (relating to tax  
25 imposed when passive investment income of corporation  
26 having accumulated earnings and profits exceeds 25 per-

1 cent of gross receipts) is amended by striking “computed  
 2 by multiplying the excess net passive income by the high-  
 3 est rate of tax specified in section 11(b)” and inserting  
 4 “15 percent of the excess net passive income”.

5 (b) EFFECTIVE DATE.—The amendment made by  
 6 this section shall apply to taxable years beginning after  
 7 December 31, 2006.

8 **SEC. 605. INCREASE IN CAP ON QUALIFIED SMALL ISSUE**  
 9 **BONDS.**

10 (a) IN GENERAL.—Section 144(a)(4)(A)(i) (relating  
 11 to general rule for \$10,000,000 limit in certain cases) is  
 12 amended by striking “\$10,000,000” and inserting  
 13 “\$10,000,000(\$30,000,000 in the case of any bank (as de-  
 14 fined in section 581) or any depository institution holding  
 15 company (as defined in section 3(w)(1) of the Federal De-  
 16 posit Insurance Act (12 U.S.C. 1813(w)(1)) which is an  
 17 S corporation)”.

18 (b) ADJUSTMENT OF CAP FOR INFLATION.—Section  
 19 144(a) (relating to qualified small issue bond) is amend-  
 20 ed—

21 (1) by redesignating paragraph (12) as para-  
 22 graph (13); and

23 (2) by inserting after paragraph (11) the fol-  
 24 lowing new paragraph:

25 “(12) INFLATION ADJUSTMENT.—

1           “(A) IN GENERAL.—In the case of any cal-  
 2           endar year after 2006, the \$30,000,000 amount  
 3           contained in paragraph (4)(A)(i) shall be in-  
 4           creased by an amount equal to—

5                   “(i) such dollar amount, multiplied by

6                   “(ii) the cost-of-living adjustment de-  
 7           termined under section 1(f)(3) for such  
 8           calendar year by substituting ‘calendar  
 9           year 2005’ for ‘calendar year 1992’ in sub-  
 10          paragraph (B) thereof.

11          “(B) ROUNDING.—Any increase under  
 12          subparagraph (A) which is not a multiple of  
 13          \$100,000 shall be rounded to the next lowest  
 14          multiple of \$100,000.”.

15          (c) EFFECTIVE DATE.—The amendments made by  
 16          this section shall apply to—

17               (1) obligations issued after the date of the en-  
 18          actment of this Act; and

19               (2) capital expenditures made after such date  
 20          with respect to obligations issued on or before such  
 21          date.

22   **SEC. 606. SPECIAL RULES OF APPLICATION.**

23          (a) WAIVER OF LIMITATIONS.—If refund or credit of  
 24          any overpayment of tax resulting from the application of  
 25          any amendment made by this Act is prevented at any time

1 before the close of the 1-year period beginning on the date  
2 of the enactment of this Act by the operation of any law  
3 or rule of law (including res judicata), such refund or cred-  
4 it may nevertheless be made or allowed if claimed therefor  
5 is filed before the close of such period.

6 (b) TREATMENT OF CERTAIN ELECTIONS UNDER  
7 PRIOR LAW.—For purposes of section 1362(g) of the In-  
8 ternal Revenue Code of 1986 (relating to election after  
9 termination), any termination or revocation under section  
10 1362(d) of such Code (as in effect on the day before enact-  
11 ment of this Act) shall not be taken into account.

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